Edmonton, Alberta T6G 2R6

AVCORP

# annual report 2003

**AVCORP**

**a leading aerospace manufacturer**

**proud supplier to**

Asian Composites
Boeing
Bombardier
Cessna
and others

## report to shareholders

We are pleased to provide this annual report to our shareholders.

During 2003 and ending in January 2004, the Company successfully completed several financial restructuring initiatives including the sale and leaseback of its facilities, re-negotiation of debt, establishing a new operating credit facility and raising over $9 million of new equity. These initiatives reduced the total debt of the Company from almost $32 million at the beginning of 2003 to less than $15 million at the end of March 2004, considerably strengthening the Company's balance sheet. We take this opportunity to thank our customers, suppliers, lenders and major shareholders for their support through the year.

Operationally, conditions remained difficult with flat year-on-year revenue. We are already experiencing revenue increases of more than 30% as new contracts signed in 2002 and 2003 enter the production phase. We are seeing a general industry recovery take hold as orders for business jets strengthen, for regional jets remain strong and for commercial jets are pointing to an increase in production rates starting in 2005.

The board of directors and management are committed to high standards of corporate governance. The Company complies with current requirements and we are taking the steps to ensure continued compliance as new standards become effective during 2004. We will continue to develop our governance practices as one of the steps we are taking to enhance value for our shareholders.

| | | | |
|---|---|---|---|
| | **DAVID LEVI**<br>Chairman | John Nicholson | **JOHN H. NICHOLSON**<br>President and CEO |

# management discussion & analysis

This Management Discussion and Analysis has been prepared as of May 7, 2004.

**Description of Business**

Avcorp Industries Inc. (the "Company") is a leading supplier of engineering design, manufactured parts, subassemblies and complex major assemblies for aircraft manufacturers. The Company's objective in order to deliver value to each of its stakeholders—shareholders, customers, lenders, employees and the community—is to be a growing, profitable business through strategies of:

- organic growth in major integrated aerostructures;
- growth and diversification through mergers and acquisitions;
- lean manufacturing principles; and
- strategically focused outsourcing.

**Financial Overview**

**Accounting Policy Changes**

During the year ended December 31, 2003, the Company discontinued its use of the percentage of completion method of revenue recognition for recurring production contracts and the program method of accounting for recording costs. These were replaced by the completed contract method where revenue is recognized when the production of a unit is completed, delivery to the customer occurs, ownership is transferred to the customer and there is a reasonable assurance of collection, and cost of sales are recorded as actual costs incurred.

These changes were made so that the financial statements more readily reflect the actual revenue, costs and cash flow of operations by eliminating the need to make estimates, particularly estimates concerning events five to ten years into the future, that may subsequently prove to be incorrect. The largest impact of the changes will be that start up costs associated with learning curves at the beginning of a new program will be expensed as incurred rather than deferred several years. Although reported earnings may reduce in the near term due to these changes, management believes that the financial statements more readily reflecting actual operations is in the best interests of all stakeholders.

These changes were adopted retroactively with restatement of prior years, increasing the Company's deficit as at October 1, 2002 by $2,871,000 representing the cumulative after-tax effect of this change on all prior periods.

The effect of the accounting policy changes on the Company's Financial Statements are as follows:

**BALANCE SHEET**
*unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars*

| | **December 31 2003 $** | December 31 2002 $ |
|---|---|---|
| Assets | | |
| Inventories | | |
| As previously reported | **13,818** | 14,439 |
| Change from prior period(s) | **(2,990)** | (2,871) |
| Change in current period: | | |
| Program accounting | **(913)** | (1,127) |
| Percentage of completion | **282** | 1,008 |
| As restated for changes in accounting policies | **10,197** | 11,449 |

**STATEMENT OF OPERATIONS**
*unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars*

| | **Year ended December 31 2003 $** | 15-months ended December 31 2002 $ |
|---|---|---|
| Revenues | | |
| As previously reported | **54,033** | 71,977 |
| Percentage of completion | **1,239** | 1,598 |
| As restated for changes in accounting policies | **55,272** | 73,575 |
| Cost of sales and expenses | | |
| Cost of sales | | |
| As previously reported | **48,775** | 66,790 |
| Program accounting | **913** | 1,127 |
| Percentage of completion | **956** | 590 |
| As restated for changes in accounting policies | **50,645** | 68,507 |
| Net loss | | |
| As previously reported | **(4,503)** | (9,058) |
| Program accounting | **(913)** | (1,127) |
| Percentage of completion | **282** | 1,008 |
| As restated for changes in accounting policies | **(5,134)** | (9,177) |

### Three-Year Results

The following table provides selected 12-month and 15-month financial information for the three periods to December 31, 2003. This information is unaudited, not adjusted for any unusual events and, in the opinion of management, presents a fair statement of the results of operations for the periods presented. Period-to-period comparisons of the Company's financial results are not necessarily meaningful and should not be relied upon as indication of future performance.

### THREE-YEAR RESULTS FOR CONTINUING OPERATIONS

*unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars except per share amounts*

| | **December 31 2003** | December 31 2002[1,2] | September 30 2001[1] |
|---|---|---|---|
| **OPERATIONS** | | | |
| Revenues | **55,272** | 73,575 | 80,404 |
| EBITDA[3,4] | **1,663** | (1,674) | 8,630 |
| Operating earnings (loss) before tax | **(3,740)** | (4,389) | 6,118 |
| Net earnings (loss) | **(5,134)** | (8,667) | 2,128 |
| Basic earnings (loss) per share | **(0.21)** | (0.53) | 0.16 |
| Diluted earnings (loss) per share | **(0.21)** | (0.53) | 0.16 |
| **FINANCIAL POSITION** | | | |
| Net capital expenditures | **311** | 1,379 | 499 |
| Total assets | **44,448** | 54,978 | 69,323 |
| Bank indebtedness and long-term debt | **17,791** | 31,858 | 34,435 |
| Shareholders' equity | **13,807** | 10,703 | 19,350 |
| Ratio: debt/equity | **1.29** | 2.98 | 1.78 |
| Ratio: current assets/current liabilities | **0.79** | 0.38 | 1.78 |
| Shares outstanding at period end | **42,108** | 18,697 | 14,612 |
| Book value per share | **0.33** | 0.57 | 1.32 |

1. As restated for changes in accounting policies
2. 15-month period from October 1, 2001 to December 31, 2002
3. EBITDA = earnings before interest, taxes, depreciation and amortization
4. EBITDA is not a recognized term under GAAP

## Quarterly Results

The following table provides selected quarterly financial information, restated to reflect change in accounting policies, for the eight most recent fiscal quarters to December 31, 2003. This information is unaudited, not adjusted for any unusual events and, in the opinion of management, presents a fair statement of the results of operations for the periods presented. Quarter-to-quarter comparisons of the Company's financial results are not necessarily meaningful and should not be relied upon as indication of future performance.

### QUARTERLY RESULTS FOR CONTINUING OPERATIONS

*unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars except per share amounts*

| | **2003** | | | | 2002 | | | |
|---|---|---|---|---|---|---|---|---|
| For the three months ended | **Dec 31** | Sep 30[1] | Jun 30[1] | Mar 31[1] | Dec 31[1] | Sep 30[1] | Jun 30[1] | Mar 31[1] |
| Revenue | **13,030** | 13,636 | 14,977 | 13,629 | 14,414 | 15,079 | 12,637 | 15,063 |
| EBITDA[2,3] | **1,509** | (369) | 1,753 | (1,230) | (1,241) | (3,362) | 856 | 679 |
| Net earnings (loss) | **(528)** | (1,504) | (137) | (2,965) | (2,569) | (4,863) | (434) | (842) |
| EBITDA per share | | | | | | | | |
| Basic | **0.04** | (0.01) | 0.09 | (0.07) | (0.07) | (0.18) | 0.06 | 0.05 |
| Fully diluted | **0.04** | (0.01) | 0.08 | (0.07) | (0.07) | (0.18) | 0.06 | 0.05 |
| Net earnings (loss) per share | | | | | | | | |
| Basic | **(0.02)** | (0.05) | (0.01) | (0.16) | (0.14) | (0.26) | (0.03) | (0.06) |
| Fully diluted | **(0.02)** | (0.05) | (0.01) | (0.16) | (0.14) | (0.26) | (0.03) | (0.06) |

1. As restated for changes in accounting policies
2. EBITDA = earnings before interest, taxes, depreciation and amortization
3. EBITDA is not a recognized term under GAAP

## 2003 and 2002 Results Overview

2003 was a year of financial restructuring while at the same time continuing with strong quality and delivery performance. For the year ended December 31, 2003, the Company recorded a loss from operations of $3,740,000 from $55,272,000 revenue as compared to an operating loss of $5,251,000 from $57,194,000 revenue in the immediately preceding 12-month period. The Company was able to reduce operating losses by strategically focusing outsourcing, reorganizing its manufacturing and assembly facility into cells, and reducing waste and lowering costs by applying lean principles across its operations.

The financial restructuring which has taken place during the year was significant:

- raised net proceeds of $7,324,000 from private placements;
- raised net proceeds of $14,206,000 from the sale of property having a net book value of $13,494,000 and resulting in a $712,000 deferred gain;
- reduced bank and other debt by $14,067,000;
- negotiated a $10,000,000 operating line of credit with a Canadian chartered bank; and
- retired $4,134,000 of further debt subsequent to year end.

Development of tooling and prototypes for the Cessna Citation CJ3 program was completed (total cost $3,840,000). First-time revenue from this program during 2003 amounted to $871,000 with revenues based on customer orders expected to reach approximately $5,000,000 in 2004. A general industry recovery has commenced with increasing deliveries for latest generation business jets. A full recovery across most segments of the industry is projected over the next two years. Two important industry developments—increased outsourcing by all major aircraft manufacturers and consolidation of suppliers—continue and are increasing in pace.

The Company's financial restructuring and investments in advanced new programs have positioned the Company for significant growth in 2004.

### Revenue

Revenue for the year ended December 31, 2003 was $55,272,000, representing an annualized 3.4% decrease from the 15-month period ended December 31, 2002. Revenues from the Company's three principal customers are as follows:

**REVENUE DISTRIBUTION**

*unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars*

| | **year ended December 31 2003** | | 15-months ended December 31 2002 | |
|---|---|---|---|---|
| | **Revenue** | **% of Total** | Revenue | % of Total |
| Bombardier | **31,145** | **56.3** | 38,576 | 52.4 |
| Boeing | **14,968** | **27.1** | 31,895 | 43.4 |
| Cessna | **7,832** | **14.2** | 1,321 | 1.8 |
| Other | **1,327** | **2.4** | 1,783 | 2.4 |
| Total | **55,272** | **100.0** | 73,575 | 100.0 |

Revenue from Boeing continued to drop in 2003. The Company's primary source of Boeing revenue is from the 737 program which dropped in rate from a pre-September 11, 2001 28 aircraft per month to 14 aircraft per month.

Full rate production for the Cessna Sovereign spar program and start-up production rates for the Cessna Citation CJ3 program occurred in 2003. It is anticipated that revenue from the Citation CJ3 and Sovereign programs will increase Cessna to over 20% of total revenue, with Bombardier, Boeing and other customer revenues decreasing proportionately. With the exception of Cessna new program rate increases, indications from Boeing and Bombardier are that production rates for 2004 will remain essentially flat.

**Gross Profit**

Gross profit increased to 8.4% for the year ended December 31, 2003 from 6.9% for the 15-month period to December 31, 2002. Supply chain initiatives consisting of outsourcing non-core competencies, re-negotiation of supplier contracts, and consolidation of the supplier base have reduced bought-in costs. Management has maintained direct labour and variable overhead costs at prior year levels. Excess plant capacity continues to cause fixed overhead costs to be disproportionately high at the current revenue levels. Anticipated higher revenue levels, as discussed previously, will utilize excess plant capacity and reduce the impact of fixed overhead costs on gross margin. Direct labour costs on new programs for 2004 will be proportionately higher than with mature programs due to the impact of a learning curve on production.

**Administration and General Expenses**

As a percentage of revenue, the administration and general expenses increased from 9.3% to 12.8%. This is attributable to financial restructuring costs, information technology infrastructure improvements and expensing of stock-based compensation (note 16).

**Non-Operating Gain**

The Company repaid $5,089,000 of its second mortgage with the Province of British Columbia, who in turn forgave the $3,340,000 balance owing (note 13(a)(ii)).

**Earnings Before Interest, Taxes, Depreciation & Amortization**

Earnings (loss) before interest, income taxes, depreciation and amortization (EBITDA) was $1,663,000 for the year ended December 31, 2003 and $(1,674,000) for the 15-month period ended December 31, 2002. Excluding the non-operating gains, EBITDA for 2003 was $(1,677,000). EBITDA for the current 12-month period was not significantly different from the 15-month 2002 period.

EBITDA is a term which does not have a standardized meaning under Canadian generally accepted accounting principles.

**Interest**

Total interest on both short- and long-term debt for the year ended December 31, 2003 was $4,667,000 and $4,158,000 for the 15-month period ended December 31, 2002. The cost of debt increased significantly during 2003 as the Company utilized bridge financing while the financial restructuring took place. Although reduced, the cost of debt will remain relatively high during 2004.

**Income Taxes**

The Company's tax provision comprises large corporation tax of $67,000 (2002: $120,000). The Company has available non-capital tax loss carry-forwards totalling approximately $12,111,000. In addition, $7,734,000 in unutilized research and development costs are available to reduce future taxable earnings.

**Loss**

The loss for the year ended December 31, 2003 was $5,134,000 compared to a loss of $8,667,000 from continuing operations for the 15-month period to December 31, 2002.

**Liquidity and Capital Resources**

The Company ended the period with bank term loans and shareholder demand loans amounting to $6,743,000 compared to a bank operating line utilization of $6,033,000 at the end of 2002. The financial instruments were utilized in part to fund working capital.

Cash utilization from operating activities, before consideration of changes in non-cash items relating to operating activities, was $7,131,000 for the year ended December 31, 2003 compared to cash utilization of $6,962,000 from continuing operations for the 15-month period ended December 31, 2002. The primary causes of the operating cash deficit were a high level of fixed overhead due to under utilized plant capacity and significant financial restructuring costs.

Non-cash operating assets and liabilities utilized $2,127,000 of cash compared to providing $163,000 in the previous year. This is primarily due to reducing the amount of past due trade payables, the timing of cash receipts at year end from customers, and continued investment in new program development costs.

A term loan in the amount of $5,524,000, with a Canadian chartered bank, became due on December 30, 2003. On the due date, the Company was in the process of refinancing this term loan with an operating line of credit and the loan was paid on January 9, 2004, by utilizing a $10,000,000 operating line of credit with a Canadian chartered bank. At March 31, 2004, the Company was not in compliance with its working capital, debt servicing and tangible net worth covenants. The Company has obtained waivers from its lenders for this non-compliance. On February 24, 2004, the Company repaid $470,000 principal and $16,000 accrued interest to December 31, 2003 on shareholder demand loans from proceeds of a private placement. The Company expects that the operating line of credit will be sufficient to meet current operational requirements. However, the increase in rate of production for Cessna programs will require additional working capital funding. These production rate increases will commence gradually in the first quarter of 2004 with full rate production by the end of 2004.

Although the Company's working capital ratio improved from 2002 (2003: 0.79:1; 2002: 0.38:1), the Company's ability to finance working capital will be its most significant constraint during the coming year.

It is the Company's intention to finance working capital through a combination of bank debt and other financial instruments.

During the year, the Company negotiated a $1,074,000 pre-payment of its note receivable from the purchaser of its former division. The remaining $600,000 is due on September 30, 2004.

The primary source of cash from investing activities was the sale and leaseback of the Company's land and building for net proceeds of $14,206,000. The proceeds were used to repay the Province of British Columbia second mortgages and bank term loans.

During the year, the Company issued 23,410,086 common shares, which provided net proceeds after expenses of $7,324,000.

Debt repayments amounted to a $6,033,000 repayment of bank line, and a $23,576,000 retirement of long-term debt. Proceeds from demand loans and term loans, which were used to fund working capital, repay bank line and repay long-term debt, amounted to $18,883,000.

During 2003, continuing operations purchased capital assets totalling $311,000 as compared to $1,379,000 during the 15-month period ended December 31, 2002.

**CONTRACTUAL OBLIGATIONS**

*unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars*

| Payments due by period | Total | 2004 | 2005 - 2007 | 2008 - 2009 | Post 2009 |
|---|---|---|---|---|---|
| Long-term debt | 8,769 | 3,769 | 2,813 | 2,187 | |
| Capital lease obligation | 1,106 | 1,106 | | | |
| Purchase obligation[1] | 31,500 | 2,358 | 6,868 | 2,867 | 19,407 |
| Other long-term obligations | 1,173 | 1,173 | | | |
| **Total contractual obligations** | 42,548 | 8,406 | 9,681 | 5,054 | 19,407 |

1. Purchase obligations include payments for information technology infrastructure outsourcing and the Company's property lease.

Principal repayments with the holder of a $5,000,000 convertible debenture were renegotiated during the last quarter of the year resulting in postponement of principal repayment to December 31, 2005, at which time 16 equal quarterly installments will be made. Subsequent to year end, the Company issued 1,026,056 units of capital stock in lieu of payment of $595,000 interest owed as at December 31, 2003. Each unit consists of one common share at a price of $0.58 and one warrant to purchase one common share at a price of $0.638 if exercised before February 19, 2005 or $0.667 if exercised between February 19, 2005 and February 19, 2006 when the warrants expire.

The remaining $2,500,000 convertible debenture along with $450,000 accrued interest to December 31, 2003 was repaid in part subsequent to year-end, with the remaining balance of $1,450,000 being forgiven by the lender.

The Company has completed the second year of a 10-year outsourcing agreement with Computer Sciences Canada Ltd. (CSC). Within the agreement, the Company is obligated to repay CSC for computer hardware and software that CSC purchased on the Company's behalf. Repayments to the end of the agreement (January 2012) currently amount to $1,546,000. CSC is obligated to provide the Company with information technology infrastructure and services for the duration of the agreement.

The Company entered into a 15-year leaseback agreement with the purchaser of the property. As part of the consideration from the sale of the property, the Company received a $1,500,000 rent credit to be applied to rent in 2008 should the Company meet certain conditions.

As at December 31, 2003, the Company was in arrears with respect to $778,000 in royalties payable to Technology Partnerships Canada (TPC). The Company expects to conclude an agreement for payment of these arrears with TPC in the second quarter.

The Company does not have any financial commitments beyond what has been outlined in the preceeding table titled Contractual Obligations. Repayment of its contractual obligations will come from funds generated by operations.

In addition to above-noted financing activities, the Company, subsequent to year-end, issued common shares totalling 3,236,855 pursuant to the exercise of share purchase warrants exercisable at a price of $0.35 per common share, providing working capital with gross proceeds amounting to $1,133,000.

The Company has only one significant planned capital expenditure for 2004 that will exceed $1,000,000. The planned capital expenditure is for non-destructive test equipment which will be financed via a capital lease or equipment loan.

The Company does not have any off-balance sheet liabilities or transactions that are not recorded or disclosed in the financial statements.

### Capital Stock

The Company is authorized to issue an unlimited number of first preferred and second preferred shares, issuable in series, the terms of which will be determined by the directors at the time of creation of each series. There were 42,107,518 common shares issued and 1,700,269 reserved at December 31, 2003. The book value of common shares issued and outstanding as at December 31, 2003 was $43,300,000.

## Operations Overview

### Background

The Company reviews its financial results on a monthly basis and periodically reviews order backlog, delivery and quality performance, productivity, supply chain initiatives and working capital utilization.

The Company has made significant progress in meeting its objectives, as indicated by continued strong delivery and quality performance, increasing order backlog, improving productivity and supply chain initiatives.

In addition, the Company expects to benefit from industry consolidation through selective mergers and acquisitions to increase the value delivered to customers and shareholders.

### Delivery and Quality Performance

The Company maintained good program delivery and quality performance throughout 2003, although some delivery delays on one new program were and continue to be experienced.

### Order Backlog

The Company operates with “general terms agreements” with its customers. These agreements are typically for five years or longer. Boeing’s long-term agreement expires in December 2005. It is the Company’s intention to negotiate a follow-on five-year agreement with Boeing. Bombardier and Cessna’s long-term agreements extend to the life of the programs. The Company is a sole-source provider for Boeing and Cessna.

The Company defines order backlog as the value of purchase orders it expects to receive from these contracts based on manufacturers’ projections and current degrees of exclusivity. Order backlog has increased over the past five years from $265 million to $509 million as the Company has signed new agreements with Cessna and renewed agreements with Bombardier and Boeing.

### Productivity

The Company uses an adjusted revenue per employee as an indicator of changes in productivity. Based on this indicator, productivity improved in 1999, 2000 and 2001. A dip in productivity in 2002 was caused by disruptions associated with changing the factory floor layout into cell-based manufacturing and assembly, higher than normal training and productivity improvement project work associated with the lean manufacturing initiative, a strike at Bombardier and slowing production rates. The productivity indicators for 2003 show an improving trend towards 2001 levels.

### Supply Chain Savings

Supply chain initiatives, including supplier development, changes to manufacturing methods and supplier managed inventory, were commenced in 2002 and their resultant cost savings are measured on a case-by-case basis. During 2003, the Company reduced its supplier base by moving to two prime suppliers of non-product consumables and to four prime suppliers of machined parts, and renegotiated supplier contracts.

### Working Capital Utilization

Working capital, defined as cash, accounts receivable and inventories less current bank financing and accounts payable, has improved over last year (2003: $3,152,000; 2002: $169,000). It should be noted that this is a non-GAAP measure.

### Financial Resources

The Company has invested in its chosen strategies of organic growth, lean manufacturing and strategic sourcing. No suitable merger and acquisition opportunities have been identified to date. Management continues to believe that these investments will provide satisfactory returns in the future, although the Company's financial resources have been depleted. Management believes that the significant investments necessary to better position the Company in the aerospace industry and the completed financial restructuring program, described earlier, position the Company to be able to face and mitigate risks associated with business and capitalize on the hard work and positive progress of the past several years.

### Non-Financial Resources

The Company's non-financial resources relate to the Company's human resources, operating equipment, systems, technologies and processes. The Company outsources all of its information technology resources. The Company does not have any extended enterprise relationships such as special purpose entities or joint ventures.

#### Human Resources

The Company has the appropriate human resources at all levels of the organization. The board of directors has considerable investment and financial expertise. The management team, represented on the board with two directors, is experienced in the industry and in all aspects of operations. All employees have appropriate qualifications and experience to perform their duties and the Company provides ongoing training and work opportunities for employee growth.

The number of employees has remained relatively constant from 2002 (2003: 405; 2002: 390). There was a slight increase in the number of employees during the latter part of the year as a ramp up for revenue growth occurred. The Company's compensation system consists of wages and salaries, benefit programs, results-based incentive pay and stock options (note 16). The Company continually reviews its compensation practices to ensure it can attract and retain employees with the necessary skills.

### Equipment, Systems, Technologies and Processes

The equipment, technologies, systems and processes—consisting of a Baan enterprise resource planning (ERP) system, computer-aided design systems, approved quality assurance procedures, modern machining centres, presses, routers, anthropomorphic robots, assembly jigs and process equipment, chemical processing, painting and metal bonding facilities—are sufficient to meet market demands for conventional aircraft parts and structures. The Company reviews emerging technologies and periodically considers its opportunities for research and development programs in such fields as advanced composites, high-speed machining and further automation of assembly. The Company has an established strategy of investing in its core competencies while outsourcing its remaining business requirements.

### Risk Assessment

The principal risks that the Company faces are summarized as follows:

- reduction in production rates of aircraft manufacturers;
- actions by the competitors; and
- potential failure to achieve cost reduction objectives.

The Company's view is that, with the financial restructuring complete and the plans for ongoing financing, the Company is in a position to face and mitigate these risks.

#### Aircraft Production Rates

Current aerospace industry analysis reports that in comparison to pre 2001, US air travel traffic was up 2.4% in January 2004. Business jet manufacturers have reported that orders for the second half of 2003 were much stronger than previously reported. Orders for regional jets are projected to remain strong and production rates for commercial jets are expected to increase in 2006.

The industry data impacts the Company as follows:

- Boeing production rates have levelled after two years of decline and consequently the Company's Boeing revenues are expected to remain constant over the next two years.
- In concurrence with industry reports, Cessna's new business jet production rates are on a steep increase. The Company expects significant revenue growth from these programs for which it is a sole-source supplier to Cessna. This growth will continue through the next two years.
- Although there exists the possibility of a flattening or slight decline in regional jet demand, the Company expects its revenue from Bombardier to remain constant for these programs.

#### Competitors

The Company competes with large firms in Europe, Asia and the United States.

Aggressive action by the Company's competitors could prevent the Company from achieving its organic growth targets. These risks are mitigated by a thorough bid review process, and through an absolute commitment throughout the Company to meeting customer expectations of on time delivery of a quality product. Except for the dual sourcing of the Bombardier CRJ700 product, management expects that any negative impact of competitors' actions would be felt by the Company over the long term because of the pre-production time associated with new projects. However, in the case of dual sourcing, the impact could be sudden and would have an equivalent impact to manufacturer production rate reduction.

It is the Company's strategy to mitigate this risk by creating a larger financial entity via a merger or acquisition.

### Cost Reductions

Approximately 60% of the Company's costs are labour related and 40% are procurement related; the procurement-related portion continues to increase with new program introduction. The Company's wage rates are generally lower than its Western European and US competitors and higher than those in Asia and Eastern Europe.

The Company continues to project year-on-year savings from its lean manufacturing and strategic outsourcing initiatives. These activities and the progress are performed and reviewed within a formal project management process, which ensures rapid corrective action if objectives are not being met. If the Company is unable to achieve these savings, profitability will not meet the required targets.

## Outlook

The Company expects Boeing and Bombardier production rates throughout 2004 to remain at essentially the same levels as at the end of 2003. The Cessna Sovereign program, which attained full rate production in 2003, will continue at this rate through 2004. The Cessna Citation CJ3 programs, which entered production during the last quarter of 2003, will achieve full rate production by the end of 2004. Overall, revenue in 2004 is expected to be approximately $70,000,000. With increased revenues, actions the Company has taken to reduce costs and the progress in the development of the Company's operations, the Company expects earnings to improve in 2004.

## Transactions with Related Parties

As a condition of obtaining short-term bank loans for 2003 and a bank operating line of credit in January 2004, the banks required joint and several guarantees from certain significant shareholders. In consideration of these guarantees, the Company entered into agreements with these shareholders having the following requirements:

### 2003 Bank Term Loan Guarantee

- issue warrants granting certain shareholders the right to purchase up to 3,652,450 common shares of the Company at an exercise price of $0.38 per share for a term of 30 months;
- accrue a fee payable in full on repayment in full of the term loans with the bank equal to 15% per annum less the bank term loan rate in effect from time to time, calculated on the daily outstanding principal balance of the term loan; and
- accrue a fee payable monthly equal to 12% per annum, calculated on the daily outstanding principal balance of the term loan.

Fees in the amount of $900,693 were paid to certain shareholders during the year. Fees payable to certain shareholders as at December 31, 2003 are $937,133. These fees are included in the statements as interest and amount to $1,837,826 for the year.

### 2004 Bank Operating Line of Credit Guarantee

- $3,500,000 limited guarantee provided jointly and severally by certain shareholders. In connection with providing a limited guarantee on the operating line of credit, certain shareholders were issued 499,998 common share purchase warrants at a price of $0.50 per share for a term of 24 months. Additionally, a consideration fee in the amount of $300,000 payable in two installments of $150,000 on July 31, 2004 and January 31, 2005, and an indebtedness fee payable quarterly equal to 6% of the $3,500,000 limited guarantee calculated on a daily basis is in effect for the operating line of credit.

In order to finance working capital during the first quarter of 2003, demand loans totalling $1,100,000 were obtained from existing shareholders. Effective January 9, 2004, the rate of interest payable on the loans was reduced from 12% to 8% per annum. Security over these loans is provided by a general security agreement, ranked prior to all other indebtedness of the Company other than existing registered charges and security interests. Total interest charged and accrued on the demand loans to December 31, 2003 is $119,000.

**Fourth Quarter**

During the fourth quarter, the Company changed its accounting policies for revenue recognition and cost of sales determination. The effects of these accounting policy changes are discussed in the Financial Overview section (note 3).

On October 2, 2003, the Province of British Columbia passed an Order in Council forgiving $3,340,000 related to second mortgages it held on the Company's property. The Company recorded the amount as non-operating gain (note 13(a)(ii)). The balance of the debt was repaid during the third quarter of 2003.

On December 30, 2003, 3,652,450 common share purchase warrants were exercised at a price of $0.38 each and 4,763,143 common share purchase warrants were exercised at a price of $0.35 each. The costs of the private placement amounting to $46,000 were deducted from the proceeds in recording an increase of $3,009,000 in capital stock.

Fourth quarter 2003 revenue was the lowest quarterly revenue of the year. This was in part due to low December shipments matching customer demand. Revenue for the first quarter of 2004 is expected to increase as new program deliveries commence. Lower revenues during the fourth quarter were a significant contributing factor to a $2,298,000 operating loss.

**Proposed Transactions**

The Company continues to pursue merger and acquisition opportunities. However, as of the date of this report, no agreements have been entered into.

**Critical Accounting Estimates**

The preparation of these financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the reported revenues and expenses.

The critical accounting estimates the Company has made relate to the following:

- Development costs, net of related government assistance, which reflect the Company's investment in new programs are recorded at $4,163,000. These costs are to be amortized over the number of units which management believes is a conservative estimate of deliveries for the program to the customer. Development costs will be written off proportionately to any anticipated reduction in expected unit deliveries to the customer. No such reduction in deliveries exist at this time. Furthermore, the Company will write off any amounts of development costs which it estimates will not be recoverable from the recurring programs to which they relate. At this time, management estimates that all development costs are recoverable.

- An estimation is made of the useful life of equipment. Useful life is measured in terms of years or on a units-of-production basis.

| | |
|---|---|
| Buildings | 40 years |
| Machinery and equipment | 2 - 15 years |
| Leasehold improvements | over the term of the lease |

  Robotics assembly equipment having a cost of $4,087,000 and a net book value of $3,379,000 is being amortized over 400 units of CRJ700 production, which is a conservative estimate of the expected number of units that the Company will deliver to Bombardier. In the event that the Company were to cease delivery on the CRJ700 program, the estimated liquidation value of the robotics would be $380,000.

- An estimation is made of the cost of the Company's stock-based compensation and other stock-based payments made in exchange for goods and services. The Company has adopted the Black-Scholes model for its fair value base method of accounting for stock options (note 16). Had the Company utilized different cost modelling techniques, management does not expect that materially differing results would have occurred.

- Revenues recognized and cost of sales recorded for long-term non-recurring contracts are estimated as follows:

  a) Revenues from long-term, non-recurring contracts are recognized using the percentage-of-completion method. The percentage complete is calculated based upon contract costs incurred to date compared with total estimated contract costs. The percentage complete is then applied to total anticipated contract revenue to determine the period's revenue. A provision for the estimated loss is made when contract costs are expected to exceed estimated contract revenue.

  b) Cost of sales for long-term, non-recurring contracts represents total contract costs, including material, direct labour and manufacturing overhead. The effect of changes to total estimated profit for each contract is recognized in the period in which the determination is made and losses, if any, are fully recognized when anticipated.

  As at December 31, 2003, no material revenues and costs of sales were estimated and recorded for long-term non-recurring contracts.

- The value of the Company's investment in Series D Preferred stock of Eclipse Aviation Corporation continues to be recorded at cost and is being held for the long-term. This estimation is based on management's review of Eclipse's financial results and forecasts. Should these forecasts significantly deteriorate, the Company would write down the investment when management determined that there had been a permanent impairment in the value of the investment.

**Financial Instruments and Other Instruments**

**Interest rate risk**

The financial instruments which expose the Company to interest rate risk are:

| | |
|---|---|
| Term loans | • Bank prime plus 1.75% (ceased January 8, 2004) |
| Operating line of credit | • Bank prime plus 0.25% on the first $5,000,000 utilized (commenced January 9, 2004)<br>• Bank prime plus 1.00% on the second $5,000,000 utilized (commenced January 9, 2004) |

The Company's mitigation of this risk is by managing utilization of the operating line of credit to the lowest amount practical. All of the Company's other financial instruments are at fixed rates.

### Currency risk

The Company sells a significant proportion of its products in US dollars at prices which are often established well in advance of manufacture and shipment dates. In addition, the Company purchases a significant proportion of its raw materials in US dollars at prices which are usually established at the order date. All of the Company's operations are based in Canada. As a result of this, the Company is exposed to currency risk to the extent that fluctuations in exchange rates are experienced.

The amount of foreign exchange gain recorded in 2003 was $786,000 (2002: $101,000). In 2004, the Company expects its US dollar-based revenues to increase disproportionately with its US dollar-based purchase of raw materials. The Company does not use derivative financial instruments to mitigate its exposure to currency risks.

### Fair value of financial instruments

The fair value of the long-term debt is estimated using present value techniques and assumptions concerning the amount and timing of expected future cash flows and discount rates which reflect current market rates on similar financial instruments.

### Forward Looking Statements

This management discussion and analysis should be read in conjunction with the Company's audited financial statements. Certain statements in this report and other oral and written statements made by the Company from time to time are forward-looking statements, including those that discuss strategies, goals, outlook or other non-historical matters; or project revenues, income, returns or other financial measures. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those contained in the statements, including the following; (a) the extent to which the Company is able to achieve savings from its restructuring plans; (b) uncertainty in estimating the amount and timing of restructuring charges and related costs; (c) changes in worldwide economic and political conditions that impact interest and foreign exchange rates; (d) the occurrence of work stoppages and strikes at key facilities of the Company or the Company's customers or suppliers; (e) government funding and program approvals affecting products being developed or sold under government programs; (f) cost and delivery performance under various program and development contracts; (g) the adequacy of cost estimates for various customer care programs including servicing warranties; (h) the ability to control costs and successful implementation of various cost reduction programs; (i) the timing of certifications of new aircraft products; (j) the occurrence of further downturns in customer markets to which the Company products are sold or supplied or where the Company offers financing; (k) changes in aircraft delivery schedules or cancellation of orders; (l) the Company's ability to offset, through cost reductions, raw material price increases and pricing pressure brought by original equipment manufacturer customers; (m) the availability and cost of insurance; (n) the Company's ability to maintain portfolio credit quality; (o) the Company's access to debt financing at competitive rates; and (p) uncertainty in estimating contingent liabilities and establishing reserves tailored to address such contingencies.

# report of management

The accompanying financial statements of Avcorp Industries Inc. and all other information contained in this Annual Report are the responsibility of management. The financial statements were prepared in conformity with Canadian generally accepted accounting principles appropriate in the circumstances, in a manner consistent with the previous year, except as disclosed in note 3 to the financial statements, and include some amounts based on management's best judgments and estimates. The financial information contained elsewhere in this Annual Report is consistent with that in the financial statements.

Management is responsible for maintaining a system of internal accounting controls and procedures to provide reasonable assurance, within an appropriate cost/benefit relationship, that assets are safeguarded and that transactions are authorized, recorded and reported properly. Management believes that the Company's internal accounting controls provide reasonable assurance that assets are safeguarded against material loss from unauthorized use or disposition, and that the financial records are reliable for preparing financial statements and other data and maintaining accountability for assets.

The Audit Committee of the Board of Directors, composed of directors, none of whom are officers of the Company, meets with the independent auditors and management to discuss internal accounting controls, auditing, and financial reporting matters. The Committee reviews, with the independent auditors, the scope and results of the audit examination. The Committee also meets with the independent auditors, without management present, to ensure the independent auditors have free access to the directors. The Committee reviews the annual financial statements and recommends their approval by the Board of Directors.

The independent auditors, PricewaterhouseCoopers LLP, are appointed by the shareholders to examine the financial statements of Avcorp Industries Inc. and to conduct such tests and related procedures as they deem necessary in conformity with Canadian generally accepted auditing standards. The opinion of the independent auditors, based upon their examination of the financial statements, is contained in this Annual Report.

| | | | |
|---|---|---|---|
| Ed Merlo | **ED MERLO**<br>Vice President, Finance and Corporate Secretary | John Nicholson | **JOHN H. NICHOLSON**<br>President and Chief Executive Officer |

# report of auditors

To the Shareholders of Avcorp Industries Inc.

We have audited the balance sheets of **Avcorp Industries Inc.** as at December 31, 2003 and 2002 and the statements of operations, deficit and cash flows for the year ended December 31, 2003 and the fifteen-month period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the periods then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

**PRICEWATERHOUSECOOPERS LLP**
Chartered Accountants

Vancouver, British Columbia

*February 23, 2004 (except for notes 1, 13 and 24 which are as at May 7, 2004)*

## Balance Sheets

as at December 31, 2003 and 2002

(in thousands of dollars)

| | 2003<br>$ | 2002<br>as restated (note 3)<br>$ |
|---|---|---|
| **Assets** | | |
| **Current assets** | | |
| Cash and cash equivalents | 2,309 | - |
| Accounts receivable | 6,561 | 4,942 |
| Note receivable (note 4) | 600 | - |
| Inventories (notes 2, 3 and 5) | 10,197 | 11,449 |
| Prepayments | 650 | 421 |
| | 20,317 | 16,812 |
| **Note receivable** (note 4) | - | 1,674 |
| **Development costs** (notes 2 and 6) | 4,163 | 3,409 |
| **Property, plant and equipment** (note 7) | 16,211 | 31,456 |
| **Investment** (note 8) | 1,527 | 1,527 |
| **Other assets** (note 9) | 2,230 | 100 |
| | 44,448 | 54,978 |
| **Liabilities** | | |
| **Current liabilities** | | |
| Bank indebtedness (note 10) | - | 6,033 |
| Demand loans (note 11) | 1,219 | - |
| Term loan (note 12) | 5,524 | - |
| Accounts payable and accrued liabilities | 9,172 | 10,189 |
| Deferred revenue | 3,678 | 2,228 |
| Current portion of long-term debt (note 13) | 6,048 | 25,488 |
| | 25,641 | 43,938 |
| **Long-term debt** (note 13) | 5,000 | 337 |
| | 30,641 | 44,275 |
| **Shareholders' Equity** | | |
| **Capital stock** (note 15) | 43,300 | 35,062 |
| **Deficit** | (29,493) | (24,359) |
| | 13,807 | 10,703 |
| | 44,448 | 54,978 |

**Nature of operations and going concern** (note 1)

**Contingencies and commitments** (note 19)

**Subsequent events** (note 24)

**Approved by the Board of Directors**

David Levi, Chairman

J. Ian Flatt, Director

## Statements of Operations

(in thousands of dollars, except per share amounts)

| | Year ended December 31 2003 | Fifteen-month period ended December 31 2002 as restated (note 3) |
|---|---|---|
| | **$** | $ |
| **Revenues** (notes 2 and 3) | **55,272** | 73,575 |
| **Cost of sales and expenses** | | |
| Cost of sales (notes 2 and 3) | **50,645** | 68,507 |
| Administrative and general expenses | **7,090** | 6,843 |
| Depreciation and amortization | **2,063** | 2,715 |
| Foreign exchange gain | **(786)** | (101) |
| | **59,012** | 77,964 |
| **Operating (loss)** | **(3,740)** | (4,389) |
| **Interest expense and financing charges** (note 17) | **(4,667)** | (4,158) |
| **Non-operating gains** (note 13(a)(ii)) | **3,340** | - |
| **(Loss) before income taxes** | **(5,067)** | (8,547) |
| **Income taxes** (note 20) | **(67)** | (120) |
| **(Loss) from continuing operations** | **(5,134)** | (8,667) |
| **(Loss) from discontinued operations** (note 4) | **-** | (510) |
| **(Loss) for the period** | **(5,134)** | (9,177) |
| **Basic and diluted (loss) per common share** | | |
| Continuing operations | **(0.21)** | (0.52) |
| Discontinued operations | **-** | (0.03) |
| **Basic and diluted weighted average number of shares outstanding (000's)** | **24,756** | 16,828 |

**Statements of Deficit**

(in thousands of dollars)

| | Year ended December 31 2003 $ | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| **Deficit - Beginning of period – previously reported** | **(21,369)** | (12,311) |
| Change in accounting policies (note 3) | **(2,990)** | (2,871) |
| **Balance at beginning of period – restated** | **(24,359)** | (15,182) |
| (Loss) for the period (note 3) | **(5,134)** | (9,177) |
| **Deficit - End of period** | **(29,493)** | (24,359) |

## Statements of Cash Flows

(in thousands of dollars)

| | Year ended December 31 2003 $ | Fifteen-month period ended December 31 2002 as restated (note 3) $ |
|---|---|---|
| **Cash flows from operating activities** | | |
| (Loss) for the period | **(5,134)** | (9,177) |
| Items not affecting cash (note 18(a)) | | |
| Continuing operations | **(1,997)** | 2,215 |
| Discontinued operations | **-** | 182 |
| | **(7,131)** | (6,780) |
| Change in non-cash items related to operating activities (note 18(b)) | | |
| Continuing operations | **(2,127)** | 163 |
| Discontinued operation | **-** | 1,169 |
| | **(9,258)** | (5,448) |
| **Cash flows from investing activities** | | |
| Proceeds from sale of discontinued operations (note 4) | **1,074** | 5,000 |
| Sale of property, plant and equipment - continuing operations (note 7) | **14,206** | 1,094 |
| Investment - continuing operations (note 8) | **-** | (1,527) |
| Purchase of property, plant and equipment | | |
| Continuing operations | **(311)** | (1,379) |
| Discontinued operations | **-** | (301) |
| | **14,969** | 2,887 |
| **Cash flows from financing activities** | | |
| Increase (reduction) in bank indebtedness | **(6,033)** | 6,033 |
| Proceeds from term loans | **18,883** | - |
| Repayment of long-term debt | | |
| Continuing operations | **(23,576)** | (8,854) |
| Discontinued operations | **-** | (56) |
| Issue of common shares | **7,555** | 5,031 |
| Share issue expense | **(231)** | (188) |
| | **(3,402)** | 1,966 |
| **Net change in cash and cash equivalents** | **2,309** | (595) |
| **Cash and cash equivalents - Beginning of period** | **-** | 595 |
| **Cash and cash equivalents - End of period** | **2,309** | - |
| **Interest paid** | **856** | 3,750 |
| **Taxes paid** | **192** | 380 |

(all figures in tables are expressed in thousands of dollars, except per share amounts)

## 1 Nature of operations and going concern

The Company is a Canadian-based manufacturer within the aerospace industry, and a single-source supplier for engineering design, manufacture and assembly of subassemblies and complete major structures for aircraft manufacturers.

The Company changed its year-end date from September 30 to December 31 in 2002. These financial statements cover the year ended December 31, 2003, with comparatives for the 15-month period October 1, 2001 to December 31, 2002.

During 2003, the aerospace industry continued to be affected by significant uncertainties in the overall economy and the geopolitical situation. These factors have affected the Company for 2002 and 2003, resulting in continued reduced revenues and a net loss for the period of $5,134,000. The Company also has a working capital deficit of $5,324,000 and an accumulated deficit of $29,493,000 at December 31, 2003.

While the accompanying financial statements have been prepared using Canadian generally accepted accounting principles applicable to a going concern, which contemplates the realization of assets and liquidation of liabilities during the normal course of operations, the losses incurred by the Company and other factors raise significant uncertainty about the Company's ability to continue as a going concern.

Subsequent to the year-end, the Company refinanced its existing debt by:

- securing a $10,000,000 operating line of credit with a Canadian chartered bank;
- repaying in full the existing bank debt totalling $5,524,000;
- repaying $1,500,000 of the $2,500,000 convertible debenture and $450,000 interest accrued to December 31, 2003;
- raising $1,133,000 from the exercise of 3,236,855 common share purchase warrants at a price of $0.35 each;
- renegotiating the payment of interest owed to a convertible debenture holder up to December 31, 2003 through the issue of 1,026,056 units at a price of $0.58 each; and by
- repaying, on February 24, 2004, $470,000 principal and $16,000 accrued interest on demand loans outstanding as at that date.

These post-year-end settlements were made through a combination of operating line usage and proceeds from private placements that closed subsequent to year-end (note 24).

At March 31, 2004, the Company was not in compliance with its working capital, debt servicing and tangible net worth covenants. The Company has obtained waivers from its lenders for this non-compliance.

The Company is continuing to minimize costs and working capital in line with revenue expectations and to implement productivity and working capital improvement initiatives. Management continues to assess a variety of options to improve liquidity and to ensure cash resources are available to meet the Company's commitments. While management currently believes the strategy summarized above includes their best options, other alternatives may develop.

Although the Company has been successful in securing new and additional financing in the past, there continues to be significant uncertainty facing the Company. In addition, the Company and the industry in which it operates continue to face macroeconomic and geopolitical uncertainties. Management believes that the refinancing activities undertaken during the year and subsequent to year-end and the ongoing efforts to reduce costs and improve productivity and working capital usage make the use of the going concern basis appropriate; however, there can be no assurance that the Company will be successful with these initiatives.

Accordingly, these financial statements do not reflect adjustments to the carrying value of assets and liabilities, the reported revenues and expenses, and balance sheet classifications used that would be necessary if the going concern assumption were not appropriate; such adjustments could be material.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

## 2 Significant accounting policies

### Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the reported revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Revenue recognition

Revenue is accounted for under two methods.

a) Revenues from recurring production contracts utilize the completed contract method whereby revenue is recognized when the production of a unit is completed, delivery to the customer occurs, ownership is transferred to the customer and there is reasonable assurance of collection.

b) Revenues from long-term, non-recurring contracts are recognized using the percentage-of-completion method. The percentage complete is calculated based upon contract costs incurred to date compared with total estimated contract costs. The percentage complete is then applied to total anticipated contract revenue to determine the period's revenue. A provision for the estimated loss is made when contract costs are expected to exceed estimated contract revenue.

### Cost of sales

a) The Company accounts for certain first-time, long-term, recurring production contracts by segmenting them into production lots. Cost of sales for each item produced within the lot is then measured at the average cost for the entire lot. Should actual costs incurred over the production lot reach the point where recovery is not anticipated, a full provision for the anticipated loss is recognized in the financial statements.

   Cost of sales for all recurring production contracts that are not segmented into production lots represents actual costs incurred.

b) Cost of sales for long-term, non-recurring contracts represents total contract costs, including material, direct labour and manufacturing overhead costs. The effect of changes to total estimated profit for each contract is recognized in the period in which the determination is made and losses, if any, are fully recognized when anticipated.

### Inventories

Raw materials are valued at the lower of cost or net realizable value. The cost of raw materials is determined on a weighted average basis. Programs and contracts in progress and finished goods are valued at the lower of standard cost (which is calculated to approximate actual costs) or net realizable value.

Inventory costs on long-term programs include raw materials, labour and applicable overheads.

### Research and development costs

Research costs are expensed as incurred. Development costs, less related government assistance, incurred on long-term programs that meet the criteria for deferral are capitalized and amortized over the number of shipsets management believes is a conservative estimate of units to be sold.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

**Translation of foreign currencies and financial instruments**

Assets and liabilities denominated in U.S. dollars are converted into Canadian dollars at the rate of exchange prevailing at the period-end. Revenue and expenses in U.S. dollars are converted into Canadian dollars at rates of exchange prevailing on transaction dates.

**Income taxes**

The Company follows the liability method of accounting for income taxes. Under this method, future income taxes are measured using the rates that are expected to apply to taxable income in the periods in which the future income tax liability or asset is expected to be settled or realized.

Future income tax assets are evaluated and if realization is not considered "more likely than not" a valuation allowance is provided.

**Property, plant and equipment**

Property, plant and equipment are recorded at cost, plus capitalized interest on large construction projects, less related government grants and investment tax credits. Depreciation is calculated using the straight-line method over the following estimated useful lives of the assets or on a units-of-production basis:

| | |
|---|---|
| Buildings | 40 years |
| Machinery and equipment | 2 - 15 years |
| Leasehold improvements | over the term of the lease |

**Investments**

Investments in which the Company does not exercise significant influence and are held for the long term are carried at cost. If management determines there is a permanent decline in value, these investments will be written down to net realizable value.

**Convertible loans and debentures**

Upon issuance, the convertible debentures and loans are classified into equity and financial components at their present value. The discount on the convertible debentures is accreted by way of a charge to earnings over the term of the debt.

**Loss per common share**

Basic loss per common share is calculated based on net loss, using the weighted average number of common shares outstanding during the year. Diluted loss per share is calculated using the treasury stock method.

**Deferred revenue**

Deferred revenue represents non-refundable deposits received on long-term contracts, and is released to revenue as the individual units are produced and shipped to the customer.

**Share purchase options**

The Company uses the fair value based approach for stock-based payments to both employees and non-employees and has chosen to record an expense for the stock options granted using the fair value method. Any consideration paid by the plan participants on the exercise of stock options or the purchase of shares will be credited to capital stock together with any related stock-based compensation expense.

Stock-based compensation expense is recognized over the vesting period for the options.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

## 3 Changes in accounting policies

### Stock-based compensation

Effective January 1, 2003, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants (CICA) with respect to accounting for stock-based compensation. Under the new recommendations, the Company charges against earnings stock-based compensation for options granted since January 1, 2003 on the basis of fair value at the date of grant in accordance with the fair value method of accounting. Previously, options issued to employees under the Company's stock option plan were treated as capital transactions with no compensation charge recognized in the statement of operations. In accordance with the transitional provisions, the Company adopted the new recommendations prospectively for awards granted after January 1, 2003, with no restatement of prior period results.

### Discontinued use of program accounting

During the year ended December 31, 2003, the Company discontinued its use of the program method of accounting. Previously, under the program method of accounting, revenue was recognized in relation to units delivered and cost of sales at the estimated average unit cost completed as a percentage of the sale price of the unit. The estimated average unit cost under program accounting was calculated by applying to the sale price of each unit produced the ratio of total estimated production costs for the entire program over the estimated sale price of all units expected to be produced in the program. Under this method of accounting, a constant gross margin was achieved in the early stages of a program by deferring a portion of the actual costs incurred for each unit delivered to the extent that they were considered recoverable from sale of units in future periods anticipated to be produced at a lower cost of production.

Programs previously accounted for using this method of accounting are now being accounted for using the completed contract method. Under the completed contract method, revenue is recognized when production of a unit is completed, ownership is transferred to the customer and there is reasonable assurance of collection. Costs to produce the units are accumulated on the balance sheet during production and are released to the statement of operations concurrently with the recognition of revenue.

### Discontinued use of percentage of completion accounting on certain programs

During the year ended December 31, 2003, the Company changed its method of revenue recognition for recurring production contracts with long production cycles from the percentage of completion accounting method to the completed contract method.

The changes in the Company's revenue and cost of sales recognition policies have been adopted retroactively with restatement of prior years, increasing the Company's deficit as at October 1, 2001 by $2,871,000, representing the cumulative after-tax effect of this change on all prior periods.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

The effect of the accounting policy changes on the Company's financial statements are as follows:

| | **December 31 2003 $** | December 31 2002 $ |
|---|---|---|
| **Balance Sheets** | | |
| Assets | | |
| Inventories | | |
| As previously reported | 13,818 | 14,439 |
| Change from prior period(s) | (2,990) | (2,871) |
| Change in current period: | | |
| Program accounting | (913) | (1,127) |
| Percentage of completion | 282 | 1,008 |
| As restated for changes in accounting policies | 10,197 | 11,449 |

| | **Year ended December 31 2003 $** | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| **Statements of operations** | | |
| Revenues | | |
| As previously reported | 54,033 | 71,977 |
| Percentage of completion | 1,239 | 1,598 |
| As restated for changes in accounting policies | 55,272 | 73,575 |
| Cost of sales and expenses | | |
| Cost of sales | | |
| As previously reported | 48,775 | 66,790 |
| Program accounting | 913 | 1,127 |
| Percentage of completion | 956 | 590 |
| As restated for changes in accounting policies | 50,645 | 68,507 |
| Net loss | | |
| As previously reported | (4,503) | (9,058) |
| Program accounting | (913) | (1,127) |
| Percentage of completion | 282 | 1,008 |
| As restated for changes in accounting policies | (5,134) | (9,177) |

## 4 Discontinued operations

Effective June 30, 2002, the Company sold its Integrated Products Division located in Quebec for net book value (excluding cash) of approximately $6,674,000. Proceeds of $5,000,000 cash were received on July 31, 2002. A further payment of $1,074,000 was received on June 11, 2003, resulting in a balance of $600,000 due September 30, 2004. The outstanding amount bears interest at the Royal Bank of Canada's prime rate plus 2% with the interest payable monthly.

The Company has entered into a supply agreement with Avior Integrated Products Inc. (Avior), the company formed by the sale of the division. Under this supply agreement, the Company expects to purchase

(all figures in tables are expressed in thousands of dollars, except per share amounts)

$4,000,000 worth of goods per year from Avior. In the event that the Company purchases less than $2,500,000 in the period culminating on September 30, 2004, the outstanding balance will then be reduced by 20% of the shortfall.

The results from discontinued operations are summarized as follows:

| | Year ended December 31 2003 $ | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| **Statements of operations of discontinued operations** | | |
| Revenues | - | 13,622 |
| (Loss) from discontinued operations before taxes | - | (134) |
| Income taxes | - | - |
| | - | (134) |
| (Loss) on disposition of net assets | - | - |
| Expenses incurred on disposition | - | (376) |
| | - | (376) |
| (Loss) from discontinued operations | - | (510) |

**Statements of net assets of discontinued operations**

The Company disposed of its Integrated Products Division on June 30, 2002 and consequently no net assets remain at December 31, 2003 and December 31, 2002.

| | Year ended December 31 2003 $ | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| **Statements of cash flows of discontinued operations** | | |
| Cash flows from operating activities | - | 1,351 |
| Cash flows from investing activities | - | (301) |
| Cash flows from financing activities | - | (56) |
| Net change in cash and cash equivalents | - | 994 |

(all figures in tables are expressed in thousands of dollars, except per share amounts)

## 5 Inventories

| | December 31 2003 $ | December 31 2002 $ |
|---|---|---|
| Raw materials | 2,598 | 2,943 |
| Programs and contracts in progress (note 3) | 6,955 | 8,261 |
| Finished products | 644 | 245 |
| | 10,197 | 11,449 |

## 6 Development costs

Development costs represent hard and soft tooling, and proto-type design costs incurred for various customer programs. These costs are amortized on a straight-line basis over the number of shipsets management believes is a conservative estimate of units to be sold.

| | December 31 2003 $ | December 31 2002 $ |
|---|---|---|
| Opening balance | 3,409 | - |
| Additions | 839 | 3,417 |
| Amortization | (85) | (8) |
| | 4,163 | 3,409 |

## 7 Property, plant and equipment

| | December 31, 2003 | | | December 31, 2002 | | |
|---|---|---|---|---|---|---|
| | Cost $ | Accumulated depreciation $ | Net $ | Cost $ | Accumulated depreciation $ | Net $ |
| Land | - | - | - | 2,314 | - | 2,314 |
| Buildings | - | - | - | 12,762 | 1,410 | 11,352 |
| Machinery and equipment | 28,982 | 12,771 | 16,211 | 28,669 | 10,879 | 17,790 |
| | 28,982 | 12,771 | 16,211 | 43,745 | 12,289 | 31,456 |

Included in machinery and equipment are assets held under capital leases at a cost of $7,060,000 (2002: $11,199,000) and accumulated depreciation of $2,531,000 (2002: $4,505,000).

On July 17, 2003, the Company sold its land and building having a net carrying amount of $13,494,000 for gross proceeds of $16,000,000, representing $1,500,000 as a rent credit and $14,500,000 for the property. Net proceeds after fees were $14,206,000.

Concurrently, the Company entered into a 15-year leaseback agreement with the purchaser of the property. The $712,000 gain arising on disposal of the property was recorded as a deferred gain in July 2003; $22,000 was brought into income during the year and the remainder will be amortized to income over the life of the lease. The rent credit from the purchaser of the property is a conditional prepaid rent towards rent in the sixth year of the lease.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

## 8 Investment

On June 17, 2002, the Company acquired 5,264 Series D Preferred Stock of Eclipse Aviation Corporation for $1,527,000.

## 9 Other assets

| | **December 31 2003 $** | December 31 2002 $ |
|---|---|---|
| Other receivable | 680 | - |
| Employee loan | 50 | 100 |
| Prepaid rent (note 7) | 1,500 | - |
| | 2,230 | 100 |

Other receivable is an amount due from a customer special order which will be recovered during fiscal 2005.

During 2000, the Company advanced $150,000 to an officer and director, which is repayable on March 15, 2005. During the year ended December 31, 2003, $50,000 of this loan was forgiven. This loan is secured by a second charge on a property and is interest free.

## 10 Bank indebtedness

During the year, the Company repaid its $6,033,000 line of credit. Interest was charged at the bank's prime rate plus 2% up until the time of repayment.

## 11 Demand loans

During 2003, demand loans totalling $1,100,000 were obtained from certain shareholders to provide working capital. These loans bear interest at 12% per annum, compounded monthly and are repayable on demand. Security over these loans is provided by a general security agreement, ranked prior to all other indebtedness of the Company other than existing registered charges and security interests. Total interest charged and accrued on the demand loans to December 31, 2003 is $119,000.

## 12 Term loan

During 2003, a short-term loan of $12,000,000 was obtained from a Canadian chartered bank, bearing interest at the Bank's prime rate plus 1.75% per annum. This loan is due on demand and expires on December 30, 2003. At December 31, 2003, $5,524,000 of this facility remained outstanding. The Bank did not call the term loan as the Company was in the final stages of establishing an operating line of credit with another bank. The term loan was repaid by the Company on January 9, 2004 (note 24(a)(i)).

(all figures in tables are expressed in thousands of dollars, except per share amounts)

As a condition of obtaining this loan, the following security has been provided:

- A general security agreement creating a first fixed charge over all present and after acquired personal property of the Company
- Assignment of all risk insurance on equipment and inventory owned by the Company to the Bank
- Joint and several guarantees of the indebtedness of the Company executed by certain shareholders
- An agreement between certain shareholders (the sponsors) and the Bank under which the sponsors jointly and severally agree, at the request of the Bank, to purchase the loan and security documents in exchange for payment to the Bank of the full amount of principal and interest outstanding under the loan
- An unconditional, irrevocable standby letter of credit, or a first security interest over cash, in the amount of $2,000,000 in favour of the Bank provided by certain shareholders
- Environmental indemnity from certain shareholders

Interest accrued to December 31, 2003 is $24,000 (see note 24 for repayment of this loan).

## 13 Long-term debt

| | **December 31 2003 $** | December 31 2002 $ |
|---|---|---|
| Land and building mortgages (a) | - | 13,798 |
| Convertible debentures (b) | 8,545 | 7,909 |
| Equipment loan (c) | 31 | 483 |
| Capital leases (note 14) | 1,106 | 2,691 |
| Government loans (d) | 193 | 196 |
| Accrued government royalties (e) | 1,173 | 748 |
| | 11,048 | 25,825 |
| Less: Current portion | (6,048) | (25,488) |
| | 5,000 | 337 |

a) Land and building mortgages:

i) During the year, the Company repaid its first mortgage with a bank (2002: $5,369,000).

ii) Second mortgages with the Province of British Columbia were repaid during the year in the amount of $5,089,000 (2002: $4,429,000 and $4,000,000). The remaining portion of the mortgages, in the amount of $3,340,000, was forgiven by the mortgage holder.

b) During 1998, the Company issued $8,000,000 of 8% convertible debentures, with $5,000,000 due August 2003, interest payable semi-annually, and convertible at the option of the holder into 1,075,269 shares at a conversion price of $4.65, and $2,500,000 due March 2003, interest payable at maturity or date of conversion, and convertible at the option of the holder into 625,000 common shares of the Company at a conversion price of $4.00 per share. The Company can require conversion of the full amount of either debenture in the event that the weighted average trading price of the Company's shares on the Toronto Stock Exchange is greater than 125% of the conversion price for 15 or 20 consecutive days depending on the specific convertible debenture. During 1998, $500,000 of these

(all figures in tables are expressed in thousands of dollars, except per share amounts)

debentures was converted into 125,000 common shares at a share price of $4.00 (note 15(a)). No principal or interest was paid on either of the two convertible debentures during the year.

The Company has renegotiated the terms of these debentures:

i) The $5,000,000 convertible debenture was amended on December 22, 2003 to give effect to the following:

- The holder waives the default in payment of arrears under the debenture.
- The debenture will continue to bear interest at the rate of 8% payable quarterly.
- $595,000 interest accrued to December 31, 2003 is payable on December 31, 2003 at the option of the Company in cash or in the equivalent number of common shares of the Company, based on the average price during the 30 trading days prior to December 31, 2003. If payment is made by way of common shares of the Company, the Company will issue to the holder one warrant per common share. Each warrant is valid for at least 24 months and entitles the holder to purchase common shares of the Company at 110% of the common share price for the first 12 months and 115% of the common share price thereafter (note 24(b)(ii)).
- Principal repayments are payable in 16 equal quarterly installments commencing on December 31, 2005, with full repayment of amounts owing by the maturity date of December 31, 2009.
- At March 31, 2004, the Company was not in compliance with its debt servicing and tangible net worth covenants. The Company has obtained a waiver from its lender for this non-compliance.

ii) The $2,500,000 convertible debenture was settled as described in note 24(a).

These debentures comprise:

| | **December 31, 2003** | | December 31, 2002 | |
|---|---|---|---|---|
| | **Equity $** | **Debt $** | Equity $ | Debt $ |
| Debentures due | | | | |
| March 2003 | 62 | 2,500 | 62 | 2,494 |
| August 2003 | 100 | 5,000 | 100 | 4,988 |
| Accrued interest | - | 1,045 | - | 427 |
| | 162 | 8,545 | 162 | 7,909 |

c) An equipment loan with an interest rate of 7.8% is secured by way of a charge against specific assets. The loan is repayable in equal instalments over a period of five years.

d) Two government non-interest-bearing loans under a manufacturing modernization program were obtained. The first loan of $1,452,000 is from the federal government and is repayable in seven consecutive annual instalments, which began on December 31, 1997. The principal outstanding as at December 31, 2003 was $193,000. The second loan of $223,000 is from the Province of Quebec and the balance of $56,600 was repaid in fiscal 2002.

e) Royalties of $1,173,000 (2002: $748,000) are payable to Technology Partnerships Canada (TPC), pursuant to the agreements detailed in note 19(b). The Company was obligated to pay TPC $778,000 of this amount on November 30, 2003. The Company is currently renegotiating its payment to TPC.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

f) Principal repayments (note 24(a)), including amounts due under capital leases, required in each of the next five years and thereafter are:

| | $ |
|---|---|
| 2004 | 6,048 |
| 2005 | 313 |
| 2006 | 1,250 |
| 2007 | 1,250 |
| 2008 | 1,250 |
| Thereafter | 937 |
| | 11,048 |

## 14 Obligations and commitments under leases

The Company has committed to payments under certain capital and operating leases relating to manufacturing machinery and equipment, and building lease costs.

Future minimum lease payments required in each of the next five fiscal years and thereafter are:

| | **December 31, 2003** | | December 31, 2002 | |
|---|---|---|---|---|
| | **Operating $** | **Capital $** | Operating $ | Capital $ |
| 2004 | 1,999 | 1,141 | - | 2,810 |
| 2005 | 2,105 | - | - | - |
| 2006 | 2,084 | - | - | - |
| 2007 | 1,978 | - | - | - |
| 2008 | 989 | - | - | - |
| Thereafter | 20,799 | - | - | - |
| | 29,954 | | | |
| Total future minimum lease payments | | 1,142 | - | 2,810 |
| Less: Imputed interest (6.80%) | | 36 | - | 119 |
| Balance of obligation under capital leases included in long-term debt (note 13) | | 1,106 | - | 2,691 |

The capital leases provide for purchase options amounting to $10 (2002: $1,463,000) exercisable at the termination of the lease period.

For the year, an amount of $890,995 representing payments under operating leases was expensed (2002: Nil).

(all figures in tables are expressed in thousands of dollars, except per share amounts)

## 15 Capital stock

Authorized

Unlimited as to number

First preferred and second preferred shares, issuable in series, the terms of which will be determined by the directors at the time of creation of each series

Common shares issued or reserved:

| | Number of shares | Amount $ |
|---|---|---|
| September 30, 2001 | 14,611,652 | 30,219 |
| Share issue (c) | 4,085,780 | 4,843 |
| December 31, 2002 | 18,697,432 | 35,062 |
| Share issue (b) | 23,410,086 | 7,324 |
| Stock-based compensation (note 16) | - | 107 |
| Fair value of warrants (note 23 and 24(a)) | - | 807 |
| December 31, 2003 | 42,107,518 | 43,300 |

a) The Company has reserved a total of 1,700,269 common shares, the maximum number that may be exercised under the terms of the convertible debentures (note 13(b)).

b) During the year, the following capital stock transactions took place:

i) On August 6, 2003, the Company issued 15,000,000 units in a private placement. Each unit was issued at $0.30 and consisted of one common share and one share purchase warrant. Two warrants will be exercisable into one additional common share of the Company at a price of $0.35 per common share for a period of six months from the date of issuance. The costs of the private placement amounting to $186,000 were deducted from the proceeds to record $4,315,000 as capital stock.

ii) On December 30, 2003, 3,652,450 common share purchase warrants were exercised at a price of $0.38 each and 4,763,143 common share purchase warrants were exercised at a price of $0.35 each. The costs of the private placement amounting to $46,000 were deducted from the proceeds to record $3,009,000 as capital stock.

iii) In December 2003, there was an adjustment of 5,507 shares to the total number of shares issued to correct a previous recording error.

c) During the 15-month period ended December 31, 2002, the following capital stock transactions took place:

i) A convertible debenture holder acquired 590,560 common shares of the Company at a price of $1.40 per common share. Costs of $13,000 were deducted from the proceeds in recording $814,000 as capital stock.

ii) The Company issued 3,400,000 units in a private placement. Each unit was issued at $1.20 and consisted of one common share and 0.5 non-transferrable share purchase warrants. Each warrant entitles the holder to purchase one additional common share at a price of $1.30 for a 12-month period expiring July 2003. The costs of the private placement amounting to $175,000 were deducted from the proceeds in recording $3,905,000 as capital stock.

iii) The Company issued 95,220 common shares as part of the 2001 bonus payment to certain employees. An amount of $124,000 was added to capital stock.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

d) The Company's incentive stock option plan is administered by the Board of Directors. The maximum number of common shares that may be optioned is 4,000,000. The period during which an option is exercisable shall not exceed 10 years. Stock options vest over periods ranging from three to five years.

A summary of the Company's stock option plan as of December 31, 2003 and December 31, 2002, and changes during the periods ending on those dates, is presented below:

| | **December 31, 2003** | | December 31, 2002 | |
|---|---|---|---|---|
| | **Shares ('000)** | **Weighted average exercise price $** | Shares ('000) | Weighted average exercise price $ |
| Outstanding - Beginning of year | 1,455 | 1.48 | 1,213 | 1.45 |
| Granted | 2,738 | 0.40 | 793 | 1.49 |
| Exercised | - | - | (32) | 1.30 |
| Forfeited | (1,330) | 1.49 | (519) | 1.44 |
| Outstanding - End of year | 2,863 | 0.52 | 1,455 | 1.48 |

The following tables summarize fixed stock options outstanding and exercisable:

Options outstanding and exercisable at December 31, 2003

| | **Number (000's)** | **Weighted average remaining contractual life (years)** | **Weighted average exercise price $** |
|---|---|---|---|
| $0.00 - $0.50 | 2,738 | 4.00 | 0.40 |
| $0.50 - $1.00 | - | - | - |
| $1.00 - $1.50 | 125 | 2.89 | 1.44 |
| | 2,863 | 3.95 | 0.52 |

Options outstanding and exercisable at December 31, 2002

| | **Number (000's)** | **Weighted average remaining contractual life (years)** | **Weighted average exercise price $** |
|---|---|---|---|
| $1.00 - $1.50 | 1,455 | 4.08 | 1.48 |
| | 1,455 | 4.08 | 1.48 |

## 16 Stock-based compensation

The Company records expenses for the fair value of the stock options granted under its incentive stock option plan using the Black-Scholes option pricing model. This model determines the fair value of stock options granted and amortizes it to earnings over the vesting period.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

In 2003, the fair value of the 2,738,000 options granted was $490,000 and the expense amortized to earnings was $107,000. The fair value was estimated using the following weighted average assumptions:

| | **2003** |
|---|---|
| Risk-free interest rate | 4.25% |
| Dividend yield | 0% |
| Expected lives | 2.83 years |
| Volatility | 91.06% |

## 17 Interest expense and financing charges

| | **Year ended December 31 2003 $** | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| Interest on capital leases | 133 | 323 |
| Interest on other long-term debt | 400 | 2,940 |
| Interest on short-term debt | 3,327 | 895 |
| Fair value of warrants (note 23 and 24(a)) | 807 | - |
| | 4,667 | 4,158 |

## 18 Supplementary cash flow information

a) Items not affecting cash:

| | **Year ended December 31 2003 $** | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| Depreciation and amortization | 2,063 | 3,257 |
| Allowance for doubtful accounts | (2) | (128) |
| Write down of inventory | (267) | (441) |
| Gain on extinguishment of debt | (3,340) | - |
| Other items | (451) | (291) |
| | (1,997) | 2,397 |

(all figures in tables are expressed in thousands of dollars, except per share amounts)

b) Changes in non-cash items:

| | Year ended December 31 2003 $ | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| Accounts receivable | (1,616) | 3,810 |
| Inventories | 765 | (2,134) |
| Prepayments | (230) | 291 |
| Accounts payable and accrued liabilities | (366) | (635) |
| Other assets | (680) | - |
| | (2,127) | 1,332 |

c) During the year ended December 31, 2003 and the fifteen-month period ended December 31, 2002, the Company conducted non-cash operating, investing and financing activities as follows:

| | Year ended December 31 2003 $ | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| **Non-cash operating activities** | | |
| Convertible debentures | | |
| Interest accrual | (1,045) | (300) |
| Royalties accrued on CRJ700 program | (425) | (442) |
| | (1,470) | (742) |
| **Non-cash financing activities** | | |
| Convertible debentures | | |
| Interest accrual | 1,045 | 300 |
| Royalties accrued on CRJ700 program | 425 | 442 |
| | 1,470 | 742 |

## 19 Contingencies and commitments

a) During 2003, the Company was served with a certificate of readiness in respect of legal action, which was commenced against the Company in 1998, for an amount of $1,000,000 in respect of alleged future remediation costs relating to a certain property located in the province of Quebec and previously owned by the Company. A statement of defence has been filed. On November 19, 2003, the Company was granted a motion to set aside the certificate of readiness and permission for the Company to prepare its defence and further assess its position. Management believes it is too early to assess the likelihood of the outcome of this litigation, and accordingly, no amounts have been accrued for in these financial statements.

b) The Company has agreements with Technology Partnerships Canada (TPC), under which TPC will make cash contributions to the Company's various projects, up to a cumulative maximum of $8,912,000. In return, a royalty will be paid to TPC by the Company based on the selling price and units

(all figures in tables are expressed in thousands of dollars, except per share amounts)

sold. During the year ended December 31, 2003, the Company received $724,000 from TPC. This amount was credited to development costs as it related directly to certain long-term programs.

c) The Company entered into a 10-year outsourcing agreement ending January 1, 2012 for information technology services. Commitments under this agreement in each of the next five years and thereafter are:

| | $ |
|---|---|
| 2004 | 359 |
| 2005 | 273 |
| 2006 | 238 |
| 2007 | 190 |
| 2008 | 136 |
| Thereafter | 350 |
| | 1,546 |

## 20 Income taxes

a) A reconciliation of income taxes at statutory rates to actual income taxes is as follows:

| | **Year ended December 31 2003 $** | Fifteen-month period ended December 31 2002 $ |
|---|---|---|
| Combined basic income tax rate | 35.6% | 39% |
| Income tax (recovery) at the basic income tax rate | (1,804) | (3,486) |
| Manufacturing and processing rate reduction | - | 302 |
| Large corporations tax | 67 | 120 |
| Other | 327 | (375) |
| Impact of change in accounting policy | (1,065) | - |
| Change in statutory income tax rate | - | (633) |
| Change in valuation allowance | 2,542 | 4,192 |
| | 67 | 120 |

(all figures in tables are expressed in thousands of dollars, except per share amounts)

b) The tax effect of temporary differences that give rise to significant portions of future tax assets and future tax liabilities as at December 31 are as follows:

| | **December 31 2003 $** | December 31 2002 $ |
|---|---|---|
| Future income tax assets | | |
| Non-capital losses | 4,314 | 2,796 |
| Scientific research expenditures | 2,755 | 2,755 |
| Capital losses | 972 | 988 |
| Property, plant and equipment | 3,903 | 3,491 |
| Gain deferred for accounting purposes | 230 | - |
| Expenses not deductible in current period | 84 | 352 |
| Financing costs | 756 | 91 |
| Investment tax credits | 1,486 | 1,485 |
| | 14,500 | 11,958 |
| Net future income tax asset | 14,500 | 11,958 |
| Less: Valuation allowance | (14,500) | (11,958) |
| | - | - |

c) The Company has available non-capital loss carry-forwards totalling approximately $12,111,000. These losses expire as follows:

| **Loss carry-forwards $** | **Expiry date** |
|---|---|
| 2,732 | 2008 |
| 1,788 | 2009 |
| 7,591 | 2010 |

d) The Company has approximately $7,734,000 of unclaimed research and development costs that may be claimed against future taxable income.

e) The Company has accumulated net capital losses for tax purposes of approximately $2,730,000 which may be carried forward and used to reduce taxable capital gains in future years.

f) The Company has income tax credits (ITC's) from Scientific Research and Experimental Development expenditures which can be applied to reduce income taxes payable in future years. The ITC's expire as follows:

| **ITC $** | **Expiry date** |
|---|---|
| 1,603 | 2007 |
| 705 | 2008 |

No future tax benefit has been recognized in these financial statements with respect to these losses.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

## 21 Financial instruments

### Interest rate risk

The Company is subject to interest rate risk to the extent that interest rates on bank indebtedness, demand loans, term loan and long-term debt fluctuate. At December 31, 2003, the Company's term loan bears interest at a variable rate (note 12); all other demand loans and long-term debt bear fixed rates of interest as detailed elsewhere in these financial statements.

### Currency risk

The Company sells a significant proportion of its products in US dollars at prices which are often established well in advance of manufacture and shipment dates. In addition, the Company purchases a significant proportion of its raw materials in US dollars at prices which are usually established at the order date. All of the Company's operations are based in Canada. As a result of this, the Company is exposed to currency risk to the extent that fluctuations in exchange rates are experienced. The Company does not use derivative financial instruments to mitigate its exposure to currency risks.

### Credit risk

Concentrations of credit risk in trade accounts receivable are with major aircraft manufacturers in the North American aerospace industry.

### Fair values

The fair values of the Company's accounts receivable, other assets, bank indebtedness, demand loans, term loan and accounts payable and accrued liabilities are estimated to approximate their carrying values due to the immediate or short-term maturity of these financial instruments. The fair value of the note receivable is estimated to approximate its carrying value as it bears interest at rates which reflect current market rates of similar financial instruments. Management has assessed that it is not practical to determine the fair value of the long-term investment which represents 5,264 Series D Preferred Stock of Eclipse Aviation Corporation as these shares are not traded in an organized financial market. The fair value of the long-term debt is estimated using present value techniques and assumptions concerning the amount and timing of expected future cash flows and discount rates which reflect current market rates on similar financial instruments.

| | **December 31, 2003** | | December 31, 2002 | |
|---|---|---|---|---|
| | **Carrying value $** | **Fair value $** | Carrying Value $ | Fair value $ |
| Long-term debt | 11,048 | 10,010 | 25,825 | 24,970 |

(all figures in tables are expressed in thousands of dollars, except per share amounts)

## 22 Economic dependence and segmented information

a) Sales to three major customers, which are covered by several programs and contracts, accounted for approximately 98% (2002: 98%) of sales.

| | **Year ended December 31, 2003** | | Fifteen-month period ended December 31, 2002 | |
|---|---|---|---|---|
| | **Revenue** | **% of Total** | Revenue | % of Total |
| Bombardier | 31,145 | 56.3 | 38,576 | 52.4 |
| Boeing | 14,968 | 27.1 | 31,895 | 43.4 |
| Cessna | 7,832 | 14.2 | 1,321 | 1.8 |
| Other | 1,327 | 2.4 | 1,783 | 2.4 |
| Total | 55,272 | 100.0 | 73,575 | 100.0 |

b) The Company operates in one industry that involves the manufacture and sale of aerospace products. As a result, the Company has only one operating segment. All of the Company's operations and assets are in Canada.

c) Export sales to the United States were approximately $24,077,000 (2002: $38,638,000). All other sales were made within Canada.

## 23 Related party transactions

The Company entered into an agreement with certain shareholders in consideration of mutual agreements with a Canadian chartered bank under which the shareholders:

- jointly and severally guarantee the indebtedness of the Company to the bank;
- jointly and severally agree, at the request of the bank, to purchase the loan and security documents in exchange for payment to the bank of the full amount of principal and interest outstanding under the loan;
- provide an unconditional, irrevocable standby letter of credit, or a first security interest over cash, in the amount of $4,450,000 in favour of the bank; and
- provide environmental indemnity.

As a condition to certain shareholders providing the above-noted security, the Company entered into an agreement with these shareholders to:

- issue warrants granting certain shareholders the right to purchase up to 3,652,450 common shares of the Company at an exercise price of $0.38 per share for a term of 30 months;
- accrue a fee payable in full on repayment in full of the term loans with the bank equal to 15% per annum less the bank term loan rate in effect from time to time, calculated on the daily outstanding principal balance of the term loan; and
- accrue a fee payable monthly equal to 12% per annum, calculated on the daily outstanding principal balance of the term loan.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

The fair value of the warrants at the date of issuance was estimated to be $731,000 using the Black-Scholes option pricing model with the following assumptions.

| | 2003 |
|---|---|
| Risk-free interest rate | 4.25% |
| Dividend yield | 0% |
| Expected lives | 2 years |
| Volatility | 96.59% |

Fees were paid to certain shareholders during the year in the amount of $904,000. Fees payable to certain shareholders as at December 31, 2003 are $818,000. These fees are included in the statements as interest and amount to $1,722,000 for the year.

Other related party transactions are disclosed elsewhere in these financial statements.

## 24 Subsequent events

a) On January 9, 2004, the Company refinanced its existing bank term loan as follows:

i) Term loans and accrued interest totalling $5,524,000 were repaid.

ii) The Company secured a $10,000,000 operating line of credit with a Canadian chartered bank having interest at prime rate plus 0.25% on the first $5,000,000 utilized and prime rate plus 1.00% on the second $5,000,000 utilized. This facility is due on demand.

As a condition of obtaining this operating line of credit, the following security has been provided:

- general security agreement registered in British Columbia providing a first charge over substantially all assets of the Company;
- general assignment of book debts registered in British Columbia;
- section 427 security over inventory registered with the Bank of Canada;
- postponement and subordination agreement from certain shareholders;
- postponement and subordination agreement with the holder of the $5,000,000 convertible debenture;
- irrevocable and unconditional guarantee of $4,000,000 by a Canadian financial institution. In consideration of the Canadian financial institution entering into and performing its obligations under this guarantee, the Company agreed to pay, on a monthly basis, a guarantee fee of 3% of the $4,000,000 unconditional guarantee calculated on a daily basis;
- $3,500,000 limited guarantee provided jointly and severally by certain shareholders. In connection with providing a limited guarantee on the operating line of credit, certain shareholders were issued 499,998 common share purchase warrants at a price of $0.50 per share for a term of 24 months. Additionally, a consideration fee in the amount of $300,000 payable in two installments of $150,000 on July 31, 2004 and January 31, 2005, and an indebtedness fee payable quarterly equal to 6% of the $3,500,000 limited guarantee calculated on a daily basis, is in effect for the operating line of credit; and
- evidence of fire and all risk insurance with the Bank as first loss payee.

At March 31, 2004, the Company was not in compliance with its working capital covenant. The Company has obtained a waiver from its lenders for this non-compliance.

(all figures in tables are expressed in thousands of dollars, except per share amounts)

On February 6, 2004, the Company repaid $1,500,000 of the $2,500,000 convertible debenture and $450,000 interest accrued to December 31, 2003. The debenture holder forgave the unpaid principal and accrued interest resulting in a $1,450,000 gain on settlement of the debt, which will be recorded in the first quarter of 2004. As consideration, the Company issued 500,000 share purchase warrants exercisable at a price of $0.35 per share for a period of six months from the date of issue of the warrants. The debenture and accrued interest are disclosed within current portion of long-term debt as at December 31, 2003.

The fair value of the warrants at the date of issuance was estimated to be $76,000 using the Black-Scholes option pricing model with the following assumptions:

| | **2003** |
|---|---|
| Risk-free interest rate | 4.25% |
| Dividend yield | 0% |
| Expected lives | 6 months |
| Volatility | 159.54% |

b) During January and February 2004, the following private placements were completed:

i) Exercise of 3,236,855 common share purchase warrants at a price of $0.35 each

ii) Issue of 1,026,056 units to a convertible debenture holder in lieu of payment of $595,000 (note 13(b)(i)) of interest owed by the Company up to December 31, 2003. Each unit consists of one common share at a price of $0.58 and one warrant to purchase one common share at a price of $0.638 if exercised before February 19, 2005 or $0.667 if exercised between February 19, 2005 and February 19, 2006 when the warrants expire.

The costs of the private placements will be deducted from the proceeds.

c) Effective January 9, 2004, the rate of interest payable on the demand loans was reduced from 12% to 8%. All other terms of the loan agreement continue in full force and effect. In February 2004, the Company repaid $470,000 principal and $16,000 accrued interest on demand loans outstanding as at that date.

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## AVCORP INDUSTRIES INC.

### Board of Directors and Officers

David Levi, Chairman of the Board (2)
President and CEO
GrowthWorks Capital Ltd.
Vancouver, British Columbia

Gordon Flatt, Director (2)
Managing Director
Coastal Corporation
Southampton, Bermuda

J. Ian Flatt, Director (1*)(2)
Chairman
The Coastal Group
Winnipeg, Manitoba

Michael C. Scholz, Director (1)(2*)
West Vancouver, British Columbia

Winston Wong, Director (1)
President
Puget Investments
Richmond, British Columbia

(1) Member of the Audit and Corporate Governance Committee
(2) Member of the Compensation and Nominating Committee
* Committee Chair

John H. Nicholson, Director
President and CEO
Avcorp Industries Inc.
West Vancouver, British Columbia

Paul Kalil, Director
Chief Operating Officer
Avcorp Industries Inc.
Vancouver, British Columbia

Ed Merlo, Corporate Secretary
Vice President, Finance
Avcorp Industries Inc.
Richmond, British Columbia

# directory

### Bank

HSBC Bank Canada
Vancouver, British Columbia

Bank of Montreal
Vancouver, British Columbia

### Legal Counsel

Lang Michener LLP
Barristers & Solicitors
Vancouver, British Columbia

### Registrar and Transfer Agent

CIBC Mellon Trust Company
Vancouver, British Columbia

### Auditors

PricewaterhouseCoopers LLP
Chartered Accountants
Vancouver, British Columbia

### Shares Listed

Toronto Stock Exchange
Symbol AVP

### Avcorp Industries Inc.

10025 River Way
Delta, British Columbia
Canada V4G 1M7

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Website: www.avcorp.com

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